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THE WAR ECONOMY

JAMES K. GALBRAITH

There is no chance that economic events will right themselves in a few weeks, or that we will be saved by such underlying factors as technology and productivity growth—or by lower interest rates or the provisions of the recent tax act. Rather, we are in for a crisis; the sooner this is recognized and acted upon, the better.

IN A WAR ECONOMY, the public obligation is to do *what is necessary:* to support the military effort, to protect and defend the home territory, and especially to maintain the physical well-being, solidarity, and morale of the people. These may not prove to be easy tasks in the months ahead.

We are facing what is not only a terror attack, but also an economic calamity. The impact of the strikes at the World Trade Center now includes a 14.4 percent drop in stock prices in the first week following the attack, and a collapse in those sectors related to travel and leisure, notably airlines, hotels, and resorts. As these events cascade through the economy, they will shatter fragile household balance sheets and precipitate steep cuts in consumer spending. The ensuing recession could be very deep and very long.

This is not merely a shock to a healthy system, requiring only limited measures to restore confidence and stimulate spending. Household finances have been badly out of balance since 1997, as the household sector financed consumption above income by borrowing, largely against capital gains. But capital gains turned negative after April 2000. Once that happened, large cuts in consumer spending could be delayed but not avoided, absent

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major policy changes. What has happened since September 11 consolidates, advances i time, and also intensifies a decline that was already well under way.

By way of a rough order of magnitude, my Levy Institute colleagues Wynne Godley and Alex Izurieta estimated last summer that unemployment would have to rise to 7.4 percent just to bring household expenditures into line with income. Unemployment would rise as high as 9.0 percent, they estimated, if households were to try to return to *normal* post–World War II saving levels. And that was on a smooth trajectory involving a gradual but not catastrophic slowdown—namely, before the events of September 11. Now it is possible that households will try even harder to restore depleted reserves, driving unemployment higher still.

There is thus no chance that events will right themselves in a few weeks, or that we will be saved by such underlying factors as technology and productivity growth—as Chairman Greenspan professes to believe—or by lower interest rates or the provisions of the recent tax act. Rather, we are in for an economic crisis; the sooner this is recognized and acted upon, the better.

This movement in Congress to lift the "budget constraint" is a welcome revival of Keynesian instinct, but proposals so far have been based on numerical guesswork and not on the objective of maintaining full employment.

Normally during wartime, large-scale support of the domestic economy is not needed, because of vast increases in military spending. However, what we face so far is not the reality of wartime mobilization, but a veneer of military action over a worldwide diplomatic and police offensive. The $20 billion already appropriated for the military may cover the costs of near-term operation but neither that nor the $20 billion allocated for relief and reconstruction in New York City is nearly enough to deal with the larger economic problem.

In total at this moment, federal spending measures of $55 billion are being considered, including the airline bailout. A further program of perhaps $100 billion may soon be proposed, including expanded unemployment insurance, extended tax rebates, and payroll tax relief. This movement in Congress to lift the "budget constraint" is a welcome revival of Keynesian instinct, but proposals so far have been based on numerical guesswork and not on the objective of maintaining full employment. As their advocates will usually acknowledge, proposals in the $100-to-200 billion range still involve accepting a severe recession, loss of tax revenue, and, no doubt, falling government spending at state and local levels no matter how much federal spending expands.

In these circumstances, the concept of "stimulus" should be discarded in favor of the larger objective of *economic stabilization*—a sustained effort commensurate with the crisis as it unfolds. Godley and Izurieta estimated before the crisis that to keep unemployment stable in the face of a reversion to zero (instead of negative) saving and no increase in exports, an

increase in federal budget deficits to 6 percent of GDP—about $600 billion—would be needed. This vast sum could be more than is actually required; dollar depreciation, especially, eases the tradeoff. But by any standard, measures so far in view are too small.

Business tax cuts, whether temporary or permanent, are useless in this situation. Without profits, reduced taxes on profits have no effect; without sales, investment is pointless even if the tax regime favors it. Both the logic and the motives of those proposing such measures are to be suspected. All wars attract profiteers; public morale will be destroyed if they succeed. For this reason, the shocking proposal to reduce capital gains taxes in the crisis was rightly shelved, for a few days at least.

A further dilemma emerges when one considers that personal tax cuts, even if temporary and targeted properly at working households, may not stimulate spending by much in a time of crisis. If households are determined to increase their financial reserves, and as they are flush with durable goods after a long expansion, increases in cash on hand may translate weakly into increased spending; such a situation could last for years. Of the available tax cuts, payroll tax rate reductions are the most likely to prove effective at stabilizing spending, because they would target households that are income-constrained. Shibboleths about the Social Security Trust Funds should not stand in the way of this simple and progressive measure; if Social Security contributes to relief of the present national crisis, then it is the government's solemn moral obligation not to use that contribution as an excuse to cut benefits later. Still, payroll tax cuts alone should not be relied on.

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Cautious men are in charge of the economy at the moment, but this attitude can only bring disaster. There no longer is any danger of overdoing fiscal policy; demand-pull inflation is not even a remote threat. The danger, at the moment, is collapse. To avert this, an initial program could be up to three times as large as what has been so far proposed.

Increases in federal spending on public health, education, transport, and other areas are also absolutely needed and should be funded liberally. But the option of revenue sharing is perhaps most readily created and implemented on a large scale, most likely to have early direct and indirect effects, least likely to be dissipated in saving or imports, and also the most nonpartisan in concept. Direct purchases by state and local governments now constitute nearly 10 percent of GDP; they have been rising rapidly in the past few years and could fall rapidly if revenues are curtailed. Preventing this, and creating new capacity for state and local action in many areas, including direct job creation, should be a very high priority at this time.

In activity on a grand scale, the federal government might extend revenue sharing to cover as much as one-fourth of total expenses this fiscal year—$300 billion—with a provisional follow-through of 20 percent in the second year and 10 percent in the third. The numbers can be adjusted as events and more refined calculations dictate, but they should be large enough to stabilize budget and service provisions at all levels of government, give state and local governments new fiscal capacity they can use at once, avert all tax increases, and permit holidays from local property and sales taxes, which would provide direct relief to middle-class and working households.

In the realm of financial issues, it is now clear that Federal Reserve policy has completely lost domestic effect. Cuts in interest rates on September 17 had no impact on the largest one-week decline in stock prices since 1933 and none on underlying economic activity. In wartime the Federal Reserve generally plays a modest role; it must simply work to bring down and hold down long-term bond rates, providing liquidity as needed to banks, companies, and households. Repeal of the out-year tax cuts now scheduled, particularly the estate tax phase-out, would help on the interest rate front. But even with this precaution, wartime monetary policy leads to a major contradiction: it is inconsistent with a stable dollar that is openly traded unless every other major power conducts policy in the same way.

To finance either a major military or a major domestic economic effort, or both, on world capital markets could very well unhinge the dollar and shift the balance of financial power—presumably to Europe.

Here, the analogy to World War II mobilization is misleading. After World War I, the United States was the world's creditor nation and held a near-monopoly on the gold stock. With the collapse of world trade in the 1930s, global economic interdependencies receded sharply; meanwhile, the United States in the late 1930s was energy self-sufficient and did not run a large trade deficit. None of these conditions now holds. In historical terms, the U.S. position today much more closely resembles that of the Great Powers in Europe in 1914 than that of the United States in 1939. As a result, a high-order Keynesian response will have global financial repercussions. To finance either a major military or a major domestic economic effort, or both, on world capital markets could very well unhinge the dollar and shift the balance of financial power—presumably to Europe.

Lower interest rates worldwide—beginning on September 17—have so far staved off a major fall in the dollar. But that situation could change, particularly if the brutality of actual hostilities or the outbreak of famine in Afghanistan or a similar calamity leads to a global shift of opinion against the United States. Oil and gas prices will follow demand downward in the short run and the recession will cut imports, improving the current account so long as exports do not continue to slump. But uncertainty over the war aims of the administration is likely to curtail activity worldwide and so add falling exports to our miseries;

moreover, oil supplies could be disrupted in a wider war, and imports will rise again if large-scale Keynesian policies take hold.

Any of these scenarios could destabilize the dollar, causing a decline far greater than the 20 to 25 percent that is probably needed for current account adjustment. There are vast public and private dollar holdings overseas—all substantially contingent on confidence that other actors will hold on to their holdings. In this crisis, they may not stand firm; a run on the dollar cannot be ruled out. This is the classic scourge of war efforts and "populist" expansions. Unless prevented, the natural reaction of the Federal Reserve would be to raise interest rates, thereby deepening the slump. An economy with high unemployment and high inflation is a very possible, even likely, result in this case.

What is to be done about this risk? An old truism in global finance holds that debtors cannot run wars—or economic recovery programs—without the organized assistance of their friends and allies. Such assistance will surely not be forthcoming, on a sustained basis, unless it involves a commitment to a more stable and successful global financial system afterward. The further reality is that the United States needs the sustained support of the world community for diplomatic, intelligence, and military purposes. This support cannot be assumed to be available free of cost, especially from poor countries that have not benefited at all from the modern global order. Therefore, like it or not, a new and more robust and stable global financial order will have to emerge from the present crisis, or we will eventually become mired indefinitely in fruitless and unending military struggles, aided by fewer and fewer reliable allies. Comprehensive debt relief for cooperating countries (Pakistan is a key example) would be a good place to begin.

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The modern system of floating exchange rates and unregulated international capital markets—just 30 years old—has never been tested on the present scale. It could easily fail now. This being so, planning for a transition in the global financial system toward an effective multilateral regulatory and stabilization system should begin quietly, but soon. It is time to examine a return to a Bretton Woods framework of fixed but adjustable exchange rates among the major currencies, backed by a multilateral reserve. This task is simplified by the creation of the euro; it would be easier now than at any time in decades to fix parities for the industrial world, allowing first for a substantial dollar depreciation. Beyond this, we will need new, perhaps regionally decentralized, exchange stabilization and liquidity facilities for the developing world.

Further, the current crisis offers compelling reasons to examine the structural sources of the U.S. trade position. Here, oil is a major factor: cutting imports totally would reduce the deficit by a quarter. Cars are a larger factor still. In the medium run, reconstruction of our transportation networks and housing patterns in a way that would rely far less on oil and automobiles (and airlines) may be the necessary domestic adjunct of real security abroad. This is particularly true if the conflict in the Persian Gulf leads to the failure of regimes on which we have depended for our presence there—Saudi Arabia and the gulf states—and to a loss of their stabilizing influence on oil. Further, a major national initiative in transportation and urban housing, planned now and launched soon, would very usefully absorb labor resources now being released into unemployment by the private sector.

The issues of global financial architecture and our national monoculture of oil and cars lie behind the present emergency; they have helped to translate a terror attack into an economic crisis. In the end, our ability to address these issues effectively will prove central to ultimate success in the quest for both physical and economic security. The immediate response should include a planning process in which these issues can be discussed freely by competent experts and without domination by partisan views or special interests.

If mass unemployment or inflation cannot be avoided by preemptive means, then the entire experience of the New Deal and the War Economy will have to be called upon in due course. But there is no point in going into all that now.

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